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PM seen and willing to abide by Chancellor's judgment — albeit very reluctantly.

TL

11/6

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

PRIME MINISTER

MLR

Gordon Richardson and I have considered again the size of the change in MLR to be announced tomorrow. We remain convinced that it should be 2 per cent.

2. An increase in MLR is, of course, as important as a signal as for its direct effect on other interest rates. A major purpose of this change would be to show our determination to take timely action to control the growth of the money supply, rather than just wait for the markets to carry up rates against us, as they almost certainly would in a few weeks time.

3. The practical purpose is even more important. We need to achieve the gilt sales necessary to fund the borrowing requirement that we have inherited. For that purpose, it is essential to avoid the danger of a subsequent feeling that the change is insufficient - as happened with Denis Healey last April. If that view gained ground in the markets, a self-fulfilling expectation of further increases would develop, and gilt sales would falter in the meantime.

4. For this primary purpose, Gordon and I both consider that a change of 2 per cent is essential. A change of 1½ per cent would be seen either as an attempt to "fine-tune" where it is not possible to do so, or as showing lack of resolve. One per

/cent would,

cent would, of course, be seen as repeating Denis Healey's mistake, and irrelevant.

5. The experience of the last few years has shown the importance of raising interest rates sufficiently and in time. The risk is largely one-sided since, if all goes well after a rise - with good gilt sales and maintenance of confidence - it is always possible to ease back and allow interest rates to fall somewhat. But if rates are not raised sufficiently in the first instance, it will probably be necessary later to go higher than would otherwise have been needed: in the meantime the monetary position would have deteriorated further.

6. On the other hand, the difference in the direct effects on the economy, (for example, on banks' lending levels and costs, between a move of 1½ per cent and 2 per cent) is not great. Even building society leaders, I understand, will be influenced, when they take their decision on the changes in mortgage and share rates (probably early next month) not so much by MLR itself, as by the then level of money market interest rates and by their expectations about the future trend of such rates. It is indeed possible that a 2 per cent change in MLR would lead to a smaller increase in building society rates than a 1½ per cent one, since the former stands a far greater chance of convincing the markets that sufficient action has been taken, and that any further shift in interest rates will be downward.

7. Finally I doubt whether the difference between 2 per cent and 1½ per cent will make much difference to the Opposition's criticism - Denis Healey, for what that is worth, will realise that he would have had to make the change. On the other hand.

/I think that

I think that, given our commitment to monetary targets, our first use of a monetary policy instrument should be effective and unequivocal.

I am sending a copy of this minute to Gordon Richardson.

(G.H.)

11 June, 1979

SECRET

Econ Pol. DS.

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10 DOWNING STREET

From the Private Secretary

11 June 1979

The Prime Minister has considered the Chancellor of the Exchequer's minute of 11 June in which he restates the case for increasing MLR by 2 percentage points tomorrow. She has noted that the Chancellor appears to be placing rather more emphasis in his argument now on the need to sell gilts as opposed to holding back lending to the private sector. In her view, his proposal to increase MLR by 2% rather than by 1½% is mistaken. However, she is willing to abide by the Chancellor's and the Governor's judgement on this matter.

I am sending a copy of this letter to John Beverly in the Governor's office.

T. P. LANKESTER

Tony Battishill, Esq.,
HM Treasury.

SECRET